November 11, 2004

Secretary
Federal Trade Commission (FTC)
600 Pennsylvania Ave. NW
Room H-159 (Annex W)
Washington, DC 20580

Re: Franchise Rule Staff Report

Dear Mr. Secretary:

Please include these comments for consideration regarding the Federal Trade Commission's ("Commission" or "FTC") proposed revised trade regulation rule (16 Part CRF Part 436), "Disclosure Requirements and Prohibitions Concerning Franchising" ("Franchise Rule", "FTC Rule" or "Rule").

The American Franchisee Association (AFA) is the largest national trade association representing the investment interests of 15,000 individuals and families who own over 30,000 franchised locations in 66 different industries. Since 1995 AFA staff and its members have participated at every opportunity afforded the general public to submit comments during the Rule revision process.

General Comments

The AFA has never been in favor of more disclosure merely for the sake of disclosure, but instead has always been interested in increasing the level of honesty and reducing the opportunity for deception during the disclosure process. We have consistently stated that we would prefer to abolish the FTC Franchise Rule as opposed to letting it become certain franchisor lawyers' medium for using an artful turn of phrase to trap, ensnare and defeat franchise investors. Our members do not need to suffer the abuses of both their franchisors and a government agency.

The patchwork quilt of Franchise Rule and existing state pre-sale disclosure laws have had little to no effect on the resulting franchise relationship and have been wholly inadequate in addressing the problems of overreaching and opportunism that current franchisees find themselves facing from certain franchisors. What is worse is that franchisors then justify their abuses by claiming that pre-sale disclosure makes abusive trade practices lawful and proper—because they were disclosed in advance. Little to no oversight compounds the problem by allowing certain franchisors and their lawyers to, quite simply, deceive franchise investors.

The AFA's goal during the lengthy Rule revision process has been to expand the Franchise Rule's disclosures to address franchisee concerns about the underlying franchise relationship. We consistently sought a disclosure "fix" for many of the post-sale relationship problems investors suffer at the hands of their franchisors.

We were pleased, therefore, to see that FTC Staff recommends expansion of the Rule's pre-sale disclosures in a few instances to address relationship issues. We were disappointed, however, in the execution of certain of those proposals. Deception of

franchise investors will continue if disclaimers and other idioms are included as proposed in certain sections of the Staff report.

Proposed Section 436.5(c)
Item 3 Litigation

First, we are pleased to see that FTC Staff recommends disclosure of predecessor corporations' litigation on the grounds that it is necessary to prevent fraud. Second, we are pleased that FTC Staff recommends franchisors be required to disclose civil actions—other than ordinary routine litigation incidental to the business—which are significant in the context of the franchise system. Third, we are also pleased that FTC Staff acknowledges the importance of including franchisor-initiated lawsuits involving the franchise relationship in Item 3. Inclusion of this information will help provide a more accurate snapshot of the state of the franchise relationship to prospective investors.

We therefore ask that the Commission retain FTC Staff recommendations in this area.

Proposed Section 436.5(s)
Item 19: Financial Performance Representation

While FTC Staff worked to revise its definition of "financial performance information" to satisfy franchisor interests (Proposed Section 436.1(e)), it missed its opportunity to correct a fatal flaw of the FTC's Franchise Rule twenty-five years after its inception. The single most vital piece of information a prospective investor needs before purchasing a franchise is earnings information. FTC Staff's failure to require that franchisors provide prospective franchisees with financial performance information in the form of an earnings claim is as unconscionable as it is incomprehensible.

Individuals invest in the stock market to make money. Similarly, individuals invest in franchises to make money. A reasonable expectation of every franchise investor is, therefore, to receive information on the financial track record of the operating units that preceded him/her. An investor should not have to ask a third party, i.e., other franchise owners, for this information. An investor should be able to receive this information from the seller of the investment--from the franchisor.

Where a franchise system has a track record of financial results, whether they are good, bad or mixed, it is inherently misleading by omission not to disclose those results. Too many franchisors and their salespeople use the FTC's failure to require full and complete disclosure to conceal the weak financial results of franchisee operations. The Securities and Exchange Commission (SEC) would never allow concealment of financial results of operations in a prospectus.

We ask that the Commission reject the FTC Staff's recommendation in this section, the end result of which would be to finally bring franchising out of the stone-age and into the 21st century by mandating franchisors provide investors with historical financial performance information, i.e., earnings claims.

Proposed Section 436.5(t)
Item 20: Outlets and Franchisee Information
2.b. Confidentiality Clauses

AFA member franchisees presented evidence at the public workshop conferences conducted by FTC Staff in 1997 about the prevalent use of confidentiality clauses as franchisees exited their franchise systems, either voluntarily or involuntarily. AFA members stated that such confidentiality clauses typically release the franchisor from legal liability and bar the franchisee (under threat of legal action) from making any oral or written statements about the franchise system or their experience with the franchised operation. The purpose of such clauses is to shut down any negative public comment about the franchise system.

FTC Staff's definition of "confidentiality clause" is any contract, order or settlement provision that directly or indirectly restricts a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor's system with any prospective franchisee. The AFA concurs with the FTC Staff definition. "Confidentiality clause" does not include clauses that protect a franchisor's trademark or other proprietary information, nor does it address clauses regarding specific contract negotiation terms and conditions.

General consensus among franchisee commentators from around the country was that if they had received truthful information from franchisees listed in the disclosure document, their decision to invest in a particular franchise would have been different. FTC Staff agreed that the use of confidentiality clauses can impede a prospective franchisee's ability to conduct due diligence investigations of franchise offerings, undercutting the primary goal of pre-sale disclosure.

We therefore ask that the Commission retain FTC Staff's recommendation that franchisors disclose in Item 20 franchisees who have signed confidentiality clauses in a franchise agreement, settlement or in any other contract during the prior three fiscal years.

2.c. Franchisee Associations

We are pleased that FTC Staff recommends that the existence of independent trademark specific franchisee associations be included in franchisors' disclosure documents. FTC Staff recommends that franchisors only disclose those trademark specific organizations whose existence is actually known to them and only if the association annually requests such inclusion in the disclosure document. Contact names and phone numbers along with e-mail and web page addresses would be provided for all disclosed associations. There is minimal burden on the franchisor to comply with this proposal.

We are not pleased, however, with FTC Staff's recommendation that the franchisor be allowed to use a two-sentence disclaimer that reads, "The following independent franchisee organizations have asked to be included in this disclosure document. We do not endorse these organizations and their members may not represent all franchisees in the [name of franchisor] franchised system." This is, to say the least, an unflattering portrayal of a source of information that may be the most important to a prospective investor, especially in the light of the absence of a lawful earnings claim disclosure in Item 19.

FTC Staff's recommended disclaimer provides no incentive to a prospective investor to contact the association. The disclaimer provides little meaningful information by its use of the phrase "may not represent all the franchisees." Most franchisor-sponsored groups rarely represent 100% of the franchisees in a given system. Why is it allowable to apply a double-standard to an independent association of franchisees?

We ask that the Commission reject FTC Staff's recommendation for use of the above two sentence disclaimer. We ask the Commission to delete the second sentence of the disclaimer and leave only the neutral first sentence: "The following franchisee organizations have asked to be included in this disclosure document." The prospect can then decide if this is an organization he/she would like to contact without any negative overtones from the franchisor and/or its sales agents.

Additional Prohibitions
Proposed Section 436.9(i)
Disclaimers and Contract negotiations
a. Integration clauses and waivers

The AFA has repeatedly maintained that franchisors should not be able to disclaim liability for or cause franchisees to waive their reliance on statements made in the franchisors' disclosure documents. The prevalent use by many franchisors of integration clauses to disclaim liability for required disclosures undermines the very purpose of the Rule, which is to prevent fraud and misrepresentation in the pre-sales process by ensuring franchisees have truthful and accurate information from which to make sound investment decisions.

We are pleased that FTC Staff recognizes that the integrity of a franchisor's disclosures is critical to prospective investors. The use of integration clauses or waivers to disclaim statements in the disclosure document that the franchisor makes or authorizes would undermine the Rule's very purpose by signaling to prospective franchisees that they cannot trust or rely upon the disclosure document.

However, it is disturbing that FTC Staff is considering the protection of franchisors from so-called "rogue" salespeople. Franchisors cannot insulate themselves from the statements of a salesperson with the use of integration clauses. The franchise salesperson--"rogue" or not--is an agent of the franchisor. The franchisor must accept responsibility for the person who it authorized and directed to sell franchises to prospective investors.

We ask that the Commission disallow franchisors' ability to strip franchisees of all rights once the franchise contract is signed through the use of sophisticated integration clauses and waivers.

Private Right of Action

Finally, the Staff report makes clear that the FTC will not address all of the issues franchisees consider substantive. Therefore, AFA members, when provided the opportunity to do so, will continue to seek legislative solutions to franchise investor problems. When the time comes, and when called upon to do so by Congress, we ask

FTC Staff to go on the record as they did in the 1970's in favor of providing a private right of action under the FTC Rule.

A private right of action would allow franchise investors their only remedy for franchisor fraud and material omissions in the thirty-eight states without state franchise registration/disclosure laws. A private right of action would also level the playing field between franchisors by taking away the unfair advantage of regional franchisors who offer only in non-registration states. These franchisors often get away with inadequate disclosure or non-disclosure because of no fear of enforcement at either the state or federal level.

Sincerely,

Susan P. Kezios
President

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